FINANCE AND HUMAN DEVELOPMENT

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Summary

Finance contributes to economic and human development, which are relatively closely related. Financial markets create "value" represented by the size of a loan, the price of a share of stock or the amount of a guarantee. Financial contracts have a time dimension, making them subject to risk. Transactions occur only when confidence offsets risk. Risk management requires the creation of confidence, which is a subjective social phenomenon.

Finance assists economic growth by creating more efficient markets through intermediation between savers and borrowers, selection of good investments, reduction of transaction costs and through integrating markets generally. Financial market reform or liberalization reduces inefficiencies, increasing the developmental role of finance. Liberalized financial markets naturally innovate, diminishing transaction costs, lengthening the time horizon of financial contracts, and refining valuation processes.

Finance contributes to human development only when finance is allowed "to do what finance can do," which is to increase efficiency by transferring purchasing power from uses with low returns to uses with higher returns; to improve decisions about saving and investment; to manage liquidity and stores of value; and to enhance risk management.

Finance attacks income poverty by increasing incomes. In the longer run and indirectly, finance helps reduce capability poverty by improving health and education. This occurs through the role of investment in upgrading skills and in providing services and physical infrastructure that improve health and longevity.

Finance is vulnerable to public policy that seeks to use it in instrumentalist ways (for specific, politically-favored purposes) that impede efficient operation of financial markets. This occurs when subsidies, taxes, quotas and regulations impose costs that exceed the value of the benefits they provide. Much of the debate about the contribution of finance to human development involves contesting views about the role of finance and the costs and benefits of instrumentalist intervention.

1. Introduction

Finance consists of three categories: exchange of money now for promises to repay or deliver in the future, money and related means of payment, and institutions that facilitate the operation of financial markets. Financial markets are arrangements where promises trade, and financial institutions are entities that process transactions. Financial institutions may be informal, deriving their legitimacy entirely from those participating in them, or formal in the sense of being legal entities subject to regulation by the State.

Financial instruments specify rights and instructions regarding the ownership and use of financial contracts. "Finance" is used very broadly here to include all these dimensions and aspects. While finance was until recently widely thought to be all about money, it is now accepted that finance is all about risk.

The primary function of financial markets is to value promises. This process rests on exploration of risk and on its management, which is achieved generically through the creation of confidence. Valuation encourages the use of funds for productive purposes and discourages their unproductive application, promoting efficient investment, contributing to economic performance. It creates choices and also reduces transaction costs.

Risk management and confidence are intertwined at social and cultural levels, underlying modern commerce, human wellbeing and successful social organization. Finance also assists the protection and preservation of physical capital, whether natural or created by people.

Human development (HD) also requires description. "To center development around people" is a phrase used by United Nations agencies. Implementation of the human development priority generally focuses on "public services" such as education, health, and infrastructure that improve the quality of life; on redistributive actions by government such as safety nets of various types and the expanded exercise of certain recently-enunciated rights; and in general on a better deal for the poor. The UNDP (United Nations Development Program) Human Development Report (HDR) 1996 provides guideposts: "To be valuable and legitimate, development...must be people-centered, equitably distributed and environmentally and socially sustainable." It adds, "Eliminating poverty requires a holistic approach to human development. Not handouts, but empowerment. Not Band-Aids, but the preconditions for self-help."

Human development efforts are often focused on poverty alleviation. HDR 1996 defines poverty not simply as lack of income. It offers "capability poverty" as a more useful and valid measure, specifying three basic capabilities: to be well nourished and healthy, for healthy human reproduction, and to be educated and knowledgeable. In many countries the capability poor far exceed the number who are income poor according to measures used in HDR 1996.

The poverty and social security focus of HD as emphasized by UN agencies and others rarely appears enthusiastic about the possibility that enterprise or commercial activities are an essential part of the HD quest and that these, too, should be stimulated as a means of advancing the general welfare and addressing the plight of the poor. For those holding a narrow view, HD may appear to depart from the nature of finance, which operates primarily by enabling individuals and groups to express their private priorities in their efforts to improve their own economic situations.

However, a holistic view of human development expands the options available to those promoting HD. Any holistic approach has to recognize and celebrate the fact that HD as measured by UNDP tends to be greatest in countries where per capita incomes are highest (excepting some wealthy oil exporting nations).

Indeed, the weak spot in finance is its attractiveness to those who advocate its use in an instrumentalist manner coupled with coercive power or with relatively low levels of accountability, i.e., as an instrument of public policy involving taxation, spending, and other laws and regulations having an impact on finance. In all respects finance is controversial, making the instrumentalist response both attractive and contestable, a centerpiece of public debate.

The role of finance is explored here on several levels, beginning with the nature of finance, relationships between finance and economic growth, policies issues involving finance and human development, and vulnerability in financial systems.

2. How Finance Works: Value, Risk and Confidence

Financial markets create "value." They do this by providing money against promises to repay, the commitment of funds in the present against promises to be honored in the future. Credit is a common example, equity shares held by owners are another, and contingent contracts such as insurance, guarantees and derivatives, are a third. These commitments and promises are created in financial markets, which include credit markets, equity or stock markets, and markets that deal in contingent contracts such as insurance and guarantees. In financial terms, the value they create by monetizing promises is measured by the amount of money they provide. Value equals the size of the loan, the price of the stock or the amount of the guarantee or insurance coverage.

2.1. Confidence and Financial Markets

This valuation process makes financial markets unique in that all financial contracts have a time dimension. This creates risk because the future cannot be accurately predicted -- risk is the certainty that things will not always work out as planned or promised. This raises the question why anyone would enter into a financial contract. The answer lies in the third building block of financial markets, after value and risk, which is confidence. Transactions occur voluntarily only when risk is offset by confidence. The balance between risk and confidence determines how much value can be created, from none at all where confidence is lacking to considerable sums where it abounds.

Confidence is generated in two ways in financial markets. Actuarial confidence predominates. It is based on experience, permitting borrowers and lenders to judge each other's promises to be fulfilled in the future using historical information about intentions, capacity and character. In modern finance some of these features can be distilled from huge databases on firms, households and individuals, making them eligible for unsolicited credit cards, for example, based on probability as structured by credit scoring systems.

Confidence is also created by guarantees. These include "hard" collateral that the lender can easily repossess and sell in the event a financial contract is dishonored, and promises by third parties, such as banks and governments, acceptable to lenders.

Confidence is the most challenging requirement for financial market development. Confidence is generated within financial markets by the same tools that are used to manage risk. In corporate finance, for example, division of finance into debt and equity creates more confidence. The legal distinction between equity and debt is that the returns to equity or ownership are variable, reflecting the performance of the enterprise, while the returns to debt are steady, as stipulated in loan contracts governing the timing and amount of repayment. Equity holders are owners, who in return for accepting the risk of loss hope to reap relatively large gains. Those providing debt expect to be repaid a fixed amount, regardless of the enterprise's performance.

The equity holders of an enterprise already have confidence in it. Their efforts to borrow to help their enterprise grow creates additional confidence, as shown by their success in attracting lenders who may not, among other reasons, have sufficient confidence to become equity holders. They are willing to lend to the enterprise, in part, because their claims have legal priority over those of the owners. Guarantees by third parties likewise provide the confidence necessary for many financial transactions.

2.2. The Social Basis of Finance

Risk and confidence make financial markets fundamentally subjective and social: they never operate in a vacuum. Confidence is therefore very strongly influenced by factors outside finance, which are expressed through what may be called a society's great institutions. It is these institutions that underlie poverty and also wealth. These great institutions define the role of the individual and of groups (including the State), determine what constitutes property and how and by whom it may be used and exchanged, govern how income and wealth are generated and deployed, define what constitutes information and how it is used, and interpret the meaning of change and specify how conflicts are managed. They determine the benefits of social activity. Society's great institutions include the State, law, commerce, education, belief systems and the media.

These institutions form society's perceptions of risks and its general view of the future. They reflect social structure and determine the amount of effort or transaction costs required to achieve and maintain consensus or to effect change. They determine the legal framework and the costs of gaining access to the legal system. These institutions have much to do with finance because risk is weighed subjectively. Risk management requires confidence, which requires consensus if it is to have a broad base. The costs of achieving any given level of consensus vary greatly from society to society, from issue to issue, and from era to era.

Great institutions are also important to the remunerative use of credit because they shape attitudes toward productive activity. For formal financial systems to work, a surplus has to be produced somewhere in the financing cycle. When credit is used, a portion of the surplus specified in advance has to be returned to the lender in the form of interest. The greater the surplus, the greater the potential role of finance in its creation and use. Does society view creation of a surplus as highly valued behavior, simply as acceptable behavior, or as suspicious behavior? To what extent does society entrust the surplus to those who directly create it, rather than finding other means for its retention and distribution?

In this respect a society's great institutions govern views of the validity of agreements entered into voluntarily. Individuals and firms that borrow or invest must be convinced that they are likely to achieve gains and that these gains will not be taken from them capriciously or arbitrarily. While interest rates are prices, they are also indicators of the time value of money (i.e., what is a dollar to be received at a specified time in the future worth today?). As such, they reflect society's view of the future, which in effect determines the cost of buying or selling the future by entering into contracts and making investments. High interest rates show less present confidence than low rates: They reflect a desire for more returns now in decisions across time.

Governments have tremendous influence on confidence. Government actions that help to create confidence include administration of justice and preservation of peace and civil order, protection of property and provision of personal security, and consistency in policy and in its application. Governments destroy confidence by failing in these respects, by creating high rates of inflation, through corruption, and by losing wars. Correlation is at work: governments that destroy confidence or are not adept at creating it are unlikely to do well in furthering human development in the long run.

2.3. Attitudes: the Power of Credit or the Scourge of Debt?

The social basis of finance is also found in views about it. For example, in Liberian vocabulary "debt" is a burden that is very difficult or impossible to repay while "credit" connotes obligations that can and have to be repaid. Many societies and religions hold debt in low esteem, discouraging its use. Virtually every language has maxims relating to debt. In English, Shakespeare admonished, "neither a borrower nor a lender be." Getting too deeply into debt has been a concern ever since the first loan was made.

Reasons for overindebtedness among informal borrowers include untenable economic situations, such as those faced by farms that cannot adapt to the decline in the "real" or inflation-adjusted prices of global agricultural output, which continuously expands. Emergencies may also lead to overindebtedness as a means of avoiding worse alternatives such as homelessness, starvation and death as distressed households sell their assets, exhaust their borrowing power and become reliant on the charity of their community. In these cases debt is more likely to be a symptom than a cause of impoverishment, although debt once incurred may be very difficult to repay, becoming a cause of continued misery.

In the formal sector the situation is more ironic. Aggressively innovative financial institutions make debt very enticing. For lenders such as banks and finance companies, this strategy usually requires a legal system that makes debt collection feasible at low cost to the creditor. However, many legal systems retard the development of finance by operating in such a way that many forms of property cannot be effectively used as collateral, restricting the debt capacity of asset owners.

Formal lenders using less formal techniques, such as microfinance institutions, do not rely on legal systems for collection. (Microfinance consists of financial services for the working poor, such as small loans that are usually defined as being less then US$ 1,000. Women are frequently targeted by microlenders.) Microlenders create relatively intense relationships with borrowers, creating incentives by promising good payers continued access to credit and opportunities for larger loans, coupled with peer group support and possibly advice on business development.

These relationships help to ensure prudent borrowing, although the common practice of offering ever-increasing loan sizes to good clients may eventually pose a threat unless other means are used to determine debt capacity. However, there is a cost to constructing and maintaining microfinance systems. Annual total costs of a number of efficient microlenders at the end of the twentieth century approximated 20 percent of the size of their loan portfolio, and this was often with subsidized funding costs. As a consequence, effective interest rates reaching 30 percent or more charged on loans have often been required for most of these lenders to become sustainable.

Modern financial markets and legal systems forgive private debts every day. Commercial banks in developed countries expect to have bad debt costs amounting to between 0.5 and 1% of commercial loans outstanding in normal years, while annual credit card bad debt losses generally range between 3 and 5% of amounts outstanding. Bankruptcy in the US has increased since softer laws were passed in the late 1970s, offering more protection to bankrupt individuals. In the late 1990s, in spite of a booming economy, personal bankruptcies surpassed one million a year. Lenders, of course, have little choice but to pass the costs of their losses on to their overall customer base, their shareholders and their employees. Thus, bad debt losses are a social cost.

3. Finance and Economic Growth

Finance matters in economic development, without which human development is retarded in the long run. Likewise, economic growth may not be achievable without human development. Financial services supplied broadly and efficiently accelerate economic growth, increase the efficiency of resource allocation, and spread wealth more broadly. There is skepticism in some quarters about the nature of these relationships, but, historically, growth and human development are correlated.

3.1. Evolving Views of Finance

However, economists have questioned the importance of financial markets. In the mid-twentieth century Joan Robinson's view was that, "Where enterprise leads, finance follows." Public policy was dominated by Keynesian thought, which held that growth in money holdings (i.e., financial assets) occurs at the expense of growth in directly productive capital such as factories and roads, retarding economic growth.

More recently, Ronald McKinnon stressed complementarity between financial development and investment in physical and intellectual capital, and Edward Shaw emphasized the growth-enhancing attributes of financial deepening through its impact on market integration. (Financial deepening occurs when the financial sector grows more rapidly than the economy as a whole. Competitive behavior assists market integration, which results in the convergence of prices over space and time for similar goods and services. This has social benefits by making prices lower and more nearly equal for larger and larger numbers of consumers and producers.)

Econometric analysis suggests that financial development is an important determinant of economic growth. Countries with superior indicators of financial deepening at any point in time show higher GDP growth rates for the next 10 or 30 years. Financial development does not simply follow economic growth. Policies favoring broad, efficient provision of financial services have a positive impact on long-term economic growth.

Economists holding positive views of the financial system note that it is a key component of the institutional infrastructure required to reduce transaction costs in the economy and for the efficient operation of all markets. (Transaction costs are basically aggravation, time and money.) The most important contribution of finance may well be its ability to foster larger and more integrated markets facilitating trade. Better performing markets promote the division of labor and specialization which increases efficiency; greater competition which lowers prices and stimulates innovation; use of modern technologies; and economies of scale (mass production and distribution reduces costs) and of scope (combining production and distribution of goods and services that are somehow related is cheaper than dealing with them separately).

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Biographical Sketch

J.D. Von Pischke is President of Frontier Finance International, based in Washington DC. The firm was founded in 1998 and is an affiliate of Internationale Projekt Consult GmbH (IPC) in Frankfurt, Germany. Both companies are dedicated solely to microfinance management and institution building, with commercial microfinance operations organized as microfinance banks or finance companies in more than 20 countries. Dr Von Pischke has an MBA from Columbia University, served in the US Peace Corps in Ethiopia as a lecturer at Haile Sellassie I University, and worked for Chase Manhattan Bank in New York, London and Monrovia. He received his PhD from the University of Glasgow, doing research on the political economy of farm credit in Kenya. From 1976 to 1995 he was a staff member of the World Bank, specializing in rural finance, industrial finance and financial policy. He was director of USAID's Financial Sector Development Project, based at Barents Group, KPMG Peat Marwick. Dr Von Pischke is the author of *Finance at the Frontier: Debt Capacity and the Role of Credit in the Private Economy*, published by the World Bank in 1991. He has co-edited five other books and has published more than 30 articles dealing with finance at the small end of the market.